

## Brazil: Political chaos or a new paradigm?

Instability remains the norm for political relations in Brasília, but the economic legislative agenda continues to advance. After a gloomy week, marked by anti-government protests and new conflicts between Congress and the executive, this week marked a significant turnaround, with lawmakers appearing to independently buy into the reform agenda



### Economic reforms advance despite political conflicts

President Bolsonaro's inability or unwillingness to engage in traditional realpolitik negotiations with the large parties in Congress has been the focus of much of the local commentary and criticism of his administration.

The situation, which has called into question lawmakers' willingness to approve fiscal reforms, is not entirely surprising. It reflects the fact that Bolsonaro was elected under an "anti-establishment" mantle, while his Congressional base is small, with "establishment" parties still commanding a large Congressional majority.

After much back-and-forth and generally failed efforts to consolidate stable majority alliances in Congress, it appears that the two sides, ie, lawmakers and the executive, are testing a new

relationship paradigm.

Instead of bargaining with the executive for Cabinet appointments in exchange for legislative support, Congress appears now more willing to support a constructive economic agenda by their own accord, often with initiatives advanced by the lawmakers themselves (such as the tax reform). For some reason, sabotaging the economic agenda in an effort to extract benefits from the executive appears to have lost its appeal.

Congress's newfound incentive to push for economic reforms was evident this week with the approval of executive decrees and the favourable statements from leaders in charge of the social security reform. This could reflect a new sense of urgency (given the poor economic indicators) or an effort to improve Congress's much-battered image, with a realization that lawmakers would also benefit from the expected post-reform economic recovery. Previously, Bolsonaro was generally seen as the primary beneficiary of the reform, but that understanding appears to have changed.

After initially rejecting the idea, Congressional leaders are no longer afraid to promote their "ownership" of the fiscal consolidation agenda, while stating that the government is harming the reform effort. Apparently, lawmakers now believe that they could glean political dividends if the reform triggers favourable economic dividends.

Three other factors may help explain the apparent change-of-heart.

- The first is that surveys now indicate that the chief legislative initiative under debate, the social security reform, is now supported by a solid majority of the population.
- The second is that, as demonstrated by the failed attempt to create two new ministries (to accommodate party demands in exchange for legislative support), social media has become a potent source of embarrassment for political parties that insist on having full control over a ministry. Thanks in large part to the attention Bolsonaro has drawn to the issue, such behaviour is now generally linked to an effort to engage in corruption practices.
- Lastly, a perception that Bolsonaro is politically vulnerable, with falling popularity and the legal troubles faced by his son (Senator Flavio Bolsonaro), and that his chance of getting re-elected have diminished, could also be a critical element of that political calculus.

Overall, local political analysts remain highly sceptical of Bolsonaro's political strategy, criticizing the president's "intransigence" or "ineptitude" in dealing with potential allies. It's been a tumultuous transition, for sure, and the smooth operators that populated former President Temer's inner circle contrast starkly with the new team, which is prone to public infighting, indiscipline and improvisations. However, in our view, it's too soon to tell if what we are witnessing is a permanent shift in political paradigm or merely a flawed political strategy.

## Timeline and risks

It's impossible to know how long the apparent détente will last, or if there's going to be an escalation of the conflict that ends up resulting in a less constructive outcome for the economic reform agenda.

Given the fractured political landscape and the large number of parties involved, along with the risk that legal developments (affecting both Congressional or government leaders) could alter the political calculus in Brasília, it is safe to assume that much could change in the coming weeks that

could alter the outcome for the reform agenda.

In any case, much of the focus should remain on the amount of changes that Congress will do to the social security reform proposal. The draft continues to be debated in the Special Committee, with **June 15** being often cited as an informal deadline for the conclusion of the debate in this committee.

Statements by lawmakers have been encouraging, suggesting a stronger-than-expected commitment to keep a high level of fiscal savings for the reform. The intention appears to keep projected savings very close to the original government proposal, with **BRL1,000bn** in 10 years often cited as a target. This compares with the government proposal of about BRL1,200bn in savings and market estimates for a final draft that results in savings in the BRL 500-700bn range.

Assuming that the reform proposal is approved by the Special Committee by the end of June, the all-important first-round vote by the entire Lower House could, in principle, take place before lawmakers adjourn for their mid-year recess, from mid-July to mid-August.

Our base-case scenario though is still that this vote will place after the mid-year break, in the **second half of August**. In this case, the reform could reach the Senate by mid-September and be fully concluded by November.

Overall, we expect the political environment to remain highly unstable, exacerbating volatility and adding a near-term weakening bias for Brazilian assets. For the USDBRL, we expect a 4.1-3.9 trading range to prevail in the nearer term, driven by external factors and, especially, the ups-and-downs of the reform negotiations. The eventual approval of the reform (July-September) would likely trigger a sharp appreciation in the BRL however, possibly towards 3.4.